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UNCLAS SECTION 01 OF 03 BRASILIA 003115

SIPDIS

SENSITIVE

NSC FOR RENIGAR, SHANNON
TREASURY FOR OASIA - DAS LEE AND FPARODI
STATE PASS TO FED BOARD OF GOVERNORS FOR ROBITAILLE
USDOC FOR 4332/ITA/MAC/WH/OLAC/JANDERSEN/ADRISCOLL/MWAR D
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E.O. 12958: N/A
TAGS: EFIN ECON PGOV EINV BR
SUBJECT: FEW ECONOMIC RISKS AS STRONG GROWTH CONTINUES; POLITICAL RISKS REMAIN

REFS: A) BRASILIA 2447

B) BRASILIA 2711
C) BRASILIA 3031

¶1. (SBU) Summary: Brazil's economic growth continues at scorching rates. According to third quarter statistics, growth in the 12 months through September 2004 was 5.3%, putting 5% growth for 2004 as a whole well within reach. Central Bank President Henrique Meirelles confirmed the rosy economic outlook in a December 8 meeting with the Ambassador. With external vulnerability reduced, Meirelles saw the balance of risks ahead shifting from the economic to the political. Pushing the microeconomic reform agenda through the Congress, he affirmed, was a sine qua non for sustaining relatively healthy growth rates. With the politically-charged election season behind it, the Congress may be able to focus on the reforms, such as the new bankruptcy law, which on December 14 finished an 11-year voyage to final approval, he added. Meirelles professed not to be panicked about the dollar's extraordinary slide on world currency markets, but thought that there would have to be an adjustment in the U.S. current account in the medium term. The Central Bank bought dollars in the Sao Paulo currency market December 6, ostensibly to bolster reserves prior to the March expiry of the IMF program (ref B). The intervention has effectively put a floor on the dollar's drop against the Real. End Summary.

¶2. (U) Recent official GoB statistics for the third quarter of 2004 show economic growth continuing at what is, for Brazil, a scorching rate. Growth in the twelve months through September 2004 clocked in at 5.3%. Financial sector expectations of 5% growth for 2004 look likely to be borne out. The data (see table below) show, however, a clear slowing trend in the quarter-on-quarter growth figures. This suggests that the economy already has begun to cool off after clocking annualized growth rates of well over six percent for the three quarters beginning in September 2003. This may be good news on the inflation front, since 1% growth quarter-on-quarter (4% annualized) is much closer to what the Central Bank currently believes is the economy's potential growth (i.e. 3% to 4%). Export growth, while still healthy, appears to be on a cooling trend as well. As an aside, overall 2003 GDP Growth of negative 0.2%, was revised upwards to positive 0.5%.

Brazilian GDP
Percent Growth - Seasonally Adjusted

	Annual/1		Quarterly Growth/2			
	2002	2003	4Q03	1Q04	2Q04	3Q04
Total GDP	1.9	0.5	1.9	1.8	1.4	1.0
Supply Side						
- Agriculture	5.5	5.0	6.2	2.1	1.2	-3.6
- Industry	2.6	-1.0	1.6	1.1	1.5	2.8
- Services	1.6	-0.1	1.3	1.1	1.4	0.7
Demand Side						
- Consumption (Private)	-0.4	-3.3	2.0	0.8	1.4	1.4
- Govt.	1.4	0.6	0.2	0.2	0.2	-0.2
- Investment	-4.2	-6.6	4.9	2.8	4.8	6.7
- Exports	7.9	14.2	8.0	4.6	2.9	1.5
- Imports	-12.3	-1.9	9.2	3.7	1.3	3.7

/1 Percent Change on Previous Year
/2 Percent Change on Previous Quarter, Preliminary
Source: Statistics and Geographic Institute (IBGE)

Living in the (Macroeconomic) Moment

¶3. (SBU) In their December 8 meeting, Meirelles told the

Ambassador that Brazil is living its best economic moment in recent memory. The combination of strong growth (expected to be about 5% for the year), inflation under control, declining debt-to-GDP ratios and a strong external balance makes this growth cycle much more sustainable than previous spurts. As Brazil's external vulnerability had fallen, Brazil risk, measured by the spread above treasuries on Brazilian Eurobonds, had fallen to about 400 basis points. With external vulnerabilities reduced, the risks Brazil faces now, Meirelles argued, were political.

¶4. (SBU) Meirelles expects growth to slow next year to what he said he "hoped" was its current potential growth rate, 3.0% to 3.5%. While acknowledging that this is slow for a country with huge social problems, Meirelles pointed out that Brazil's average growth over the last decade had been 1.8%. People underestimate the damage that the lack of macroeconomic stability did to growth potential, Meirelles affirmed. With stability restored, businesses had a planning horizon and could begin to invest again. This investment initially grabbed the "low-hanging fruit," boosting productivity by de-bottlenecking or adding shifts at factories. This initial round of productivity increases, he stated, likely could sustain growth at about 3.5%. It was crucial, to push the microeconomic reform agenda, which would begin the hard work of increasing productivity -- and thereby potential growth.

Inflation and Investment

¶5. (U) Two pieces of data in the recently released statistics, the growth in investment and the growth in industry, speak to the twin issues of inflation and investment that Meirelles and the Central Bank face right now (ref A). Industrial growth in the third quarter was 2.8% over the previous quarter, continuing a surprisingly strong upward trend. This reflects record capacity utilization in many industries, according to recent surveys. The high level of capacity utilization appears to be driving some of the inflationary pressure that the Central Bank currently is trying to wring out of the system, including with its December 15 interest rate hike (to 17.75%), the third in as many months. The second surprising result was the 6.7% growth in investment for the third quarter. Investment growth has exceeded GDP growth in each of the last four quarters, which bodes well for increasing capacity and productivity and improving sustainable growth rates. This data, however, does not reflect the impact on investment, if any, of the Central Bank's interest rate hikes since September.

Bankruptcy Law Passed

¶6. (U) After an eleven-year journey through the Brazilian Congress, a law reforming Brazil's bankruptcy code was passed December 14. The bill now goes to the President for signature. The new law aims to create the opportunity, as Chapter 11 of the U.S. bankruptcy code does, for firms in financial straits to negotiate a restructuring with their creditors outside the courtroom. Only if the company and its creditors were unable to reach agreement on a restructuring, would there be a need for a judge to become involved. In the event that a company ultimately is declared bankrupt and liquidated, the new law gives commercial creditors higher priority to collect their debts than under the old system, addressing a longstanding bankers' complaint. Banks will now be second in line to collect debts from the bankrupt company, after employees. Under the previous law, debts to the government had seniority over commercial creditors and there were no limits on how much a judge could award to workers.

Dollar's Slide

¶7. (U) Meirelles told the Ambassador there was "no reason to panic" about the dollar's slide in world currency markets in the short term, but that U.S. current account must adjust in the longer term. Brazilian businesses, however, have been expressing deep concern that the dollar's fall will price them out of export markets. Against that backdrop, the Central Bank intervened in the foreign exchange markets December 6 to purchase an unknown, but likely relatively modest, amount of dollars. The day after, the dollar appreciated 0.37%. The Bank has said that this was merely the first of several planned small purchases in its effort to begin rebuilding its foreign exchange reserves ahead of the March 2005 expiration of the IMF program. The markets have interpreted the move as a clear signal that the Central Bank will not accept an exchange rate below R$2.7.

Comment

¶8. (SBU) The GoB's primary task now is working to increase the level of sustainable growth, a process which entails implementation of the microeconomic reform agenda. With the municipal elections behind it, the GoB is in a better position to focus on moving the reform agenda through Congress. The post-election passage of the bankruptcy reform as well as passage of a portion of the judicial reform are welcome signs that the Congress may be returning to the job. But, the departure of the PMDB and PPS from the governing coalition to better position themselves for the 2006 presidential elections, while by no means crippling the GoB's ability to get its legislative agenda through Congress, may mean a more chaotic road ahead (ref C).

DANILOVICH